Contractors, directors' loan accounts and borrowing company money

Contractors can enjoy a long and lucrative contracting career without ever needing to take a director's loan from their limited company, But for those that do, there are strict HMRC rules and legislation, and multiple pitfalls to navigate.

"Borrowing money from your own company and never paying it back could be a great way to save on higher rate tax," jokes **James Abbott**, owner and head of tax at contractor accountant **Abbott Moore**. "However, not surprisingly the government realises this and has imposed strict rules on directors' loan repayments and severe tax penalties if the loan is not repaid when due." The relevant legislation is known as Section 455 tax (previously Section 419 tax)."

The basic principle is that a director can take a loan, but if they do and don't pay back quickly enough, HMRC is going to effectively charge the company the higher rate tax (25%) that would have been paid if the cash had been taken as a **dividend**. And when the contractor repays the loan, HMRC will give the company back the additional tax it paid.

What is a director's loan?

Every limited company contractor has a director's loan account, although most will never use it. The loan account is in credit if the company owes the contractor director money, and is in debit if the contractor has taken money out of their company that is not salary, expenses or declared as a dividend.

"Contractors may find that in the early days of their contracting career their director's loan account is in credit," continues Abbott. "This is typically because the contractor may have put their own money into the business when it started to buy a computer and pay for professional fees, such as incorporation and contract expenses.

"A contractor might find they are in receipt of a director's loan, which can also be known as 'loans to participator', if they have taken cash out of the business without declaring a dividend or paying salary.

"The fact that the director is a shareholder in a close company, which is defined as being controlled by five or fewer shareholders, creates the problem. If the director did not have any shares the S455 charge would not arise. "

Director's loan accounts are also caused unwittingly as a result of an illegal dividend. This is when a contractor withdraws cash from the business when there are no, or not enough, profits to declare a dividend. In this case, the payment may be called a director's loan.

Loan paperwork

If a contractor decides to borrow from the company using their director's loan account, they should ensure a board minute is created and signed confirming the arrangement, irrespective of the amount.

And company law requires that loans over £10,000 have to be approved at a shareholders meeting, normally via an ordinary resolution.

"A full-blown loan agreement is not required for a director's loan," say Abbott. "An ordinary resolution for shareholders and a board minute will suffice."

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> James Abbott, Abbott Moore

Repayment rules – Section 455 tax (formerly Section 419 tax)

A director's loan must be paid back within 9 months and one day from the end of the company's accounting period in which the contractor borrowed the money. So, if a contractor took a £10,000 loan on 28 March 2013 and their limited company had a 31 March year end, they have until 1 January 2014 to repay the loan.

"If a contractor fails to repay the loan on time, the company must pay a supplementary corporation tax charge, known as Section 455 tax (and formerly known as Section 419 tax) of 25% of the loan's value," warns Abbott.

There is also no minimum amount. If a contractor borrows £100 and fails to repay the loan within 9 months and one day then the company must pay Section 455 tax at 25% of the loan – £25.

Claiming back Section 455 tax from HMRC

"If a contractor misses the repayment deadline and their company pays the tax, they can claim it back from HMRC," confirms Abbott. "If the contractor repays the loan and applies to HMRC for the return of their Section 455 tax, it is refunded 9 months and one day after the accounting period in which the contractor repaid their loan."

So, using the above example of taking a loan of £10,000 on 28 March 2013, if the contractor does not repay the loan by 1 January 2014, and before 30 April

2014, the repayment would fall into the 2014/2015 financial year, which ends on 31 March 2015.

That means the Section 455 tax won't be repaid until 1 January 2016. "The repayment delay is really important and catches out many contractors. Failing to repay the loan four months after the due date results in a two-year delay in recovering the tax," adds Abbott.

In practical terms, most likely is that HMRC will deduct the Section 455 tax refund from any outstanding corporation tax liability, but contractors still have to write to HMRC as repayment is not automatic.

How to show a loan is repaid

According to Abbott, contractors can clear an overdrawn loan account either by physically moving cash around, or through a 'set-off' arrangement, such as declaring a dividend and the board minutes expressing that the dividend should be credited to the director's loan account, rather than repaying the loan with cash.

"It is better to physically transfer cash between personal and company accounts because this minimises the chances of HMRC arguing over the timing of the transaction," urges Abbott.

"A contractor drawing down a director's loan in expectation of clearing it with a salary payment risks HMRC arguing that any Pay As You Earn (PAYE) income tax and National Insurance Contributions should be paid to HMRC based upon the date when the money is first withdrawn by the director, not the later credit for the salary."

Benefit in kind (BIK)

In addition to the Section 455 tax, contractors taking a director's loan also have to contend with benefit in kind rules. These are complicated, because contractors who wear more than one hat, ie are limited company shareholders/directors/employees, are governed by two sets of legislation and tax rules.

Abbott explains: "If a contractor's loan exceeds the capped amount any time in the tax year, they pay benefit in kind. That's because the contractor has a benefit from their limited company employer which is not charging them interest on the loan."

The capped amount for the 2013/14 financial year is £5,000. This is due to rise to £10,000 from 6 April 2014.

The company must pay class 1A National Insurance Contributions (NICs) at 13.8% on the benefit in kind. For example, if a contractor borrows £6,000 over the complete tax year, the benefit in kind is calculated using the 'beneficial loan rate', which is an interest rate set by HMRC for each financial year, to create an interest payment on which the contractor can pay BIK.

The rate is 4% (at the time of writing), so £6,000 x 4% = £240. The contractor's limited company must pay 13.8% of £240, which is £33.12. The payment is recorded on the P11D form of the contractor director.

The contractor then has to pay personal tax on the benefit in kind, which is the £240 of interest they would otherwise be paying to their employer for the loan. As with all benefits in kind, the tax charge is calculated at the contractor's highest marginal rate. So, for a contractor paying higher rate tax, they would pay £240 x 40% = £96.

"Although benefit in kind may be a small sum of money in comparison to the loan amount, unlike Section 455 tax it cannot be recovered," says Abbott. "Contractors should consider the costs of borrowing the money from their company before making the decision."

Directors taking 'commercial loans' from their company

It may appear tempting to borrow company money on a commercial basis to use for personal investments, but Abbott warns contractors that this is tantamount to recycling their own money and creating a tax deduction only to be taxed elsewhere.

"Benefit in kind rules may not apply to a commercial loan, but when you look at the sums the numbers do not add up. There is still the Section 455 tax."

Loans made to directors are also classed as assets to the business. This could cause problems if a contractor is trying to use Entrepreneur's Relief to close their company, as a large director's loan may raise a question mark over the 20% test required to use Entrepreneur's Relief.

It is also not possible to make loans to a spouse or other partner in the business if they are also a director or significant shareholder, because it will also be classed as a 'loan to a participator' and be covered by the same rules.

2013 Budget changes and Finance Act proposals

"HMRC is finding that directors are repaying loans before the 9 months and one day deadline, but then borrowing the money again shortly afterwards," notes Abbott. "A new rule is proposed in the Finance Act 2013 to tackle this issue.

"It is proposed that transactions within 30 days of each other are ignored for the purposes of meeting the 9 months and one day rule. So, if a contractor repays their loan within the 9 months and one day deadline, and then borrows again within 30 days, HMRC treats the transaction as if it never happened, and Section 455 tax is still due.."

In a similar vein, another proposal says that if an overdrawn loan account exceeds £15,000, and the contractor makes a repayment, and it was intended or planned at the time that the contractor would borrow the money again, the repayment transaction does not count for S455 purposes.

Directors' loans: a very public way of borrowing money

In addition to being potentially expensive, Abbott highlights that director's loans can be a very public, and potentially messy way to borrow money: "Loans must be fully disclosed in company accounts at Companies House; they appear as a separate item in a corporation tax return and show on a company director's P11D.

"HMRC can, and often do, challenge loans and reclassify them as salary. That leaves limited company contractors with income tax, employee's NICs and employer's NICs liabilities, which can be substantial."

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Abbott concludes: "The treatment of director's loans is the final nail in the coffin of contractors being able to sort out their tax affairs after the financial year has ended. The paperwork has to be very tight and is often time critical. Contractors should decide immediately how to classify payments they make from their company to themselves."

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